



| CAPITAL FORMATION |

# Capital Formation

An updating tutorial, plus a controversial opinion and a warning



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Given the importance of capital formation to all companies, this article will refresh understandings and possibly stimulate some thinking in regard to the capital market for mature (non-emerging) companies.

**The "Cap Cake"**

It might be useful to visualize the capital market as a "layer cake" with each layer applicable to a different form of financing or capital based on that layer's specific risk/return characteristic (the "cap-cake," or capitalization continuum), with the top layer entailing the least amount of risk (and cost/return), and the bottom layer entailing the opposite. The applicability, parameters, and variances associated with each of the cap cake's layers remain dependent on a company's: 1) earnings quality and size, 2) asset composition, and 3) past, present and future performance. The cap-cake has 4.5 layers, and each (including the half layer) is described as follows:

**Senior Debt**

This top layer entails lines of credits, revolving credits, and term loans typically provided by banks. These facilities are either "asset-based," requiring very tight control via regular availability calculations; or cash flow based entailing a first lien on assets. Prime or Libor is used as the funding bases and spreads can reach up to 7%. The average term loan maturity is 5 years. Short-term facilities usually bridge cash flow gaps, while term loans have uses aligned with the loan's maturity (e.g., equipment purchases). The dynamic within senior debt is the degree to which "air" will be provided

(the non-collateralized portion of a loan). Larger companies are typically funded by syndicated deals or issue senior debt notes. Senior debt is usually maximized within an optimized cap structure.

**Subordinated Debt**

This layer has caused the most disruption in the capital market because it is filling the chasm between inexpensive senior debt and expensive mezzanine capital. Predominantly, although not exclusively, non-bank lenders are providing this type of "secured" funding with first-in-last-out (FILO) loans, pure second lien loans, EV and second lien loans, and even third lien participations. The all-in cost or return range is about 7% to 12%. Since these facilities are secured, the asset configuration of the borrower is a key determinant in regard to accessing this layer. These facilities are structured investments by the lender, so the prepayment penalties are costly.

**Mezzanine Capital**

This layer of capital is considered unsecured and usually linkages are made to a company's equity. Mezzanine capital can be conveyed in the form of: 1) a term loan with, and sometimes without warrants, entailing favorable amortization schedules (e.g., balloon at maturity) 2) a convertible note or security or 3) the many iterations of preferred stock (e.g., redeemable, participating, etc.). The all-in cost or return ranges from 12% to 35%. Usually the cash-based interest rate is 10%-15%, deferred interest is charged (PIK), sometimes an OID is applied (smaller deals), and equity warrants entailing a minority interest position are

granted (the warrants are the key IRR/cost accelerator). Given the high interest rate, cash flow stability is a key determinant for considering this layer.

### Unitranche Debt

This is the referenced “half-layer” of the cap-cake, and it is rapidly expanding, especially for companies with \$5m to \$15m in EBITDA. The unitranche is a hybrid form of funding entailing two, and maybe three layers of the cap-cake. Specifically, a first lien is provided, and the typically non-bank lender will offer a blended rate based on providing a debt facility that entails the senior debt, some or all of the subordinated debt, and possibly some of the mezzanine capacity. The all-in cost ranges from roughly 6% to 12%. The benefit to the lender is a highly secured position (sometimes first-lien allocations are made to other parties), while the benefit to the borrower is an overall lower cost of funds, vs. an a la carte arrangement, and no inter-creditor agreement wrangles.

### Equity Capital

The last and most costly layer pertains to equity, which can be provided by the private or public markets. There are about 2,800 private equity firms sponsoring 17,400 companies. The private equity marketplace has about \$380b of available capital, and this industry is segmented by groupings of firms willing to invest in, or buy companies with EBITDA of \$1m, \$3m, \$5m, \$10m, \$20m, etc. The U.S. public market in 2013 was the most active in 13 years with issuance of \$238b of equity securities, including \$58b raised by about 200 IPO's hallmarked by: 1) 53% being profitable companies vs. 47% in 2000, and 2) SPX P/E of 14.5x vs. 20.0x in 2000 (about 25 IPO's had values of less than \$100m). Equity valuations are higher than historic levels, but are not considered excessive.

### Soap-Box Time

As you think about slicing the cap-cake in an optimal manner for your company,

I will offer something controversial. In short, unless a company has EBITDA of \$20m or more, as many institutional investors are precluded from investing in smaller companies, or a company has a truly globally transforming offering, smaller companies should not consider the public option to raise equity. Further, it is my view most existing micro-caps should be private, and reverse mergers are counterproductive. The basis of this opinion is that I simply do not see a benefit for a smaller company being public, unless the public market is the port of last resort. The dramatic efficiency of the private market has created an effective equality with respect to liquidity, without the diversified burdens and costs of remaining a public company. If an initial market can be created and an IPO issued, the “music” tends to stop. Typically, the post-IPO research is spotty, the float is thin (creating valuation issues), and how many broker-dealers support secondary market prices with the actual commitment of capital? Further, there are a variety of company-specific issues that remain challenges for larger companies, let alone smaller companies. So, my advisement is the private equity marketplace can well accommodate the need for equity capital.

### A Warning

As a result of virtually all of the economic indicium trending positively, inflation remaining below the 2% inflection point, a lack of interest rate movement related to the first tapering given the Fed's position that the Fed Funds Rate may be held near zero even if employment declines below 6%, the increasing amount of loan turnover demand, tremendous market liquidity, \$1.4t in cash on company balance sheets, the desire for yield, etc., something is taking place which bears watching . . . This is the escalation of leverage multiples (total debt divided by EBITDA), and the resulting decline of equity within capitalization structures. Leverage multiples are thought to be their highest, and the equity component

in structures the lowest, within at least 13 years. Is a new bubble beginning to simmer?

Here are some leverage multiple indications based on EBITDA size: < \$7.5m 3.00x to 4.25x, \$10m > 3.75x to 5.00x, and \$25m > 4.00x to 5.75x. Leverage multiples are composed of senior debt multiples and non-senior debt multiples (the later range is 1.0x to 2.5x). So, for a company with EBITDA of \$7.5 million the total debt capacity, including senior, subordinated and mezzanine might range from \$22.5m to \$31.9m. In regard to equity layers, the amount of equity in new capitalization structures is now 32% (50% in 2009). As a result, increasing leverage multiples are expanding debt capacities and transaction structures are becoming well (overly?) levered. A reversal of this trend will begin upon the advent of defaults precipitated by factors that very few will be able to anticipate.

### Summary Statement

In closing, the capital market is hungry for capital formation transactions, so if your company has either a value-creating opportunity requiring funding (remember, the marketplace will always support these propositions) or an interest in maximizing its capitalization structure, it is a propitious time to advantage the present conditions.

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